Supreme Court of the United States

OCTOBER TERM, 1944.

NEVILLE COKE & CHEMICAL COMPANY,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

The citations of the opinions below, the basis of the jurisdiction of this Court, the statement of facts and the question presented are set forth in the attached Petition, and therefore are not repeated here.

Specifications of Error.

The United States Circuit Court of Appeals erred:

(1) in holding that the three, four and five year notes of Davison Coke & Iron Company were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936;

(2) in holding that the gain realized by petitioner upon the exchange of said notes for new debentures and common stock of the debtor was recognized and taxable in full;

(3) in failing to hold that no gain was recognized to petitioner upon the exchange of said notes, together with first mortgage bonds, prior preferred, preferred and common stocks of Davison Coke & Iron Company for new debentures and common stock of the debtor;

(4) in failing to hold that no gain was recognized and taxable to petitioner upon said exchange; and

(5) in affirming the decision of the Tax Court of the United States.

Argument.

A writ of certiorari should be issued to review the judgment of the Circuit Court of Appeals for the Third Circuit in the instant case for the following reasons:

1. The decision below holding that corporate notes, relinquished by petitioner in the 77B proceedings for the reorganization of the debtor in exchange for new debentures and common stock of the reorganized company, were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936, is in conflict with *Burnham* v. *Commissioner, supra,* where the Seventh Circuit held that an unsecured corporate note, exchanged two years after its issuance, was a "security" within the meaning of identical provisions of the Revenue Act of 1928.

2. The decision below is in conflict with the decisions of this Court in *Pinellas Ice & Coal Storage Company* v. *Commissioner* and *LeTulle* v. *Scofield, supra.* The Circuit Court of Appeals has construed these decisions to require a "security" to represent a "proprietary" interest in the corporation, whereas neither decision purports to define the meaning to be attributed to the term "securities" as used in the non-recognition provisions of the tax laws.

3. The decision of the Circuit Court of Appeals holding that corporate notes are not "securities" within the meaning of the non-recognition provisions of the tax laws raises a novel and important question of construction of Federal law which should be reviewed by this Court, particularly as it impinges upon exchanges carried out in connection with creditors' reorganizations in 77B, Chapter X and related proceedings.

4. An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions of the Revenue Acts and Internal Revenue Code is important to a proper administration of the revenue laws.

I.

The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Burnham* v. *Commissioner*.

The decision below holds that three, four and five year notes, relinquished by petitioner in the 77B reorganization of the debtor in exchange for new debentures and common stock of the reorganized company, were not "securities" under Section 112(b)(3) of the Revenue Act of 1936. This conclusion is in conflict with the Seventh Circuit decision in *Burnham* v. *Commissioner, supra.*

In the *Burnham* case the taxpayer owned two unsecured notes of a corporation, one for $402,500 and the other for $5,000, on which partial payments of $125,000 had been made. The notes were payable at the option of the maker at any time before their maturity, which was ten years from the date of issuance. These notes were exchanged by the taxpayer, within two years of the date of issuance, for stock of the issuer. The taxpayer claimed a loss on the transaction equal to the difference between the cost basis of the notes and the value of the stock received. The Commissioner of Internal Revenue denied the deduction on the ground that there was an exchange of "stock or securi-

ties" in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization, and that on such a transaction no loss was recognized under Section 112(b)(3) of the Revenue Act of 1928.

Section 112 of the Revenue Act of 1928 was, in all respects material in the instant case, identical with Section 112 of the Revenue Act of 1936. Moreover the instant case and the *Burnham* case both involve recapitalizations, and the terms and provisions applicable to both cases are the same. The fact that the term of the obligation in the *Burnham* case exceeded that of the Davison notes does not serve to distinguish the cases, for this Court has said, in *LeTulle* v. *Scofield,* 308 U. S. 415, 420 (1940), in discussing the classification of securities, that the term of the obligations is not material.

The taxpayer in the *Burnham* case argued that the term "security" included,

> "only more formal evidence of property, such as, long-term series notes designed for distribution among investors, bonds, stock, and the like" (33 B. T. A. 149).

The Board of Tax Appeals and the Circuit Court of Appeals rejected this argument and held in favor of the Commissioner that the note was a "security."

The taxpayer applied to this Court for a writ of certiorari. The Commissioner, in opposing the application, stated in his Brief, at page 6:

> "The term 'securities', when used without qualification or restriction, as in the statute here involved, includes promissory notes—both in popular speech and in law. See *First National Bank* v. *United States,* 38 F. (2d) 925, 930 (C. Cl.), affirmed, 283 U. S. 142.

> The petitioner would give it a narrower and special meaning, but the language of the statute is to be read in its natural and common meaning. *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560."

This Court denied certiorari, 300 U. S. 683 (1937).

The decision of the Circuit Court of Appeals in the instant case is squarely in conflict with the decision of the Seventh Circuit in the *Burnham* case.

II.

The decision of the Circuit Court of Appeals misapplies, and is in conflict with, the decisions of this Court in *Pinellas Ice & Cold Storage Company* v. *Commissioner* and *LeTulle* v. *Scofield*.

In support of its conclusion that the notes of the debtor were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936, the court below cites *Pinellas Ice & Cold Storage Company* v. *Commissioner* and *LeTulle* v. *Scofield, supra*. Neither of these cases, however, considers the meaning to be given to the term "securities". Both cases apply the doctrine of "continuity of interest", and in each case this Court considered the obligations only in so far as they indicated whether there had been a "reorganization" in the technical sense or whether there had been a taxable sale. In the instant case the debtor was recapitalized and it is not disputed that there was a "reorganization". The only issue is whether the notes were "securities"—a question entirely separate and distinct from questions considered under this Court's interpretation of "reorganization".

The court below, after referring to *LeTulle* v. *Scofield, supra,* as drawing "the distinction between a case where, after the reorganization, the transferee [*sic*] retained a proprietary interest in the enterprise or simply became a creditor", posed the question:

> "Did the notes which the taxpayer held against Davison Company give it a 'proprietary' interest in the enterprise or was it only a creditor?" (R. p. 122)

Thus, the Circuit Court of Appeals adverts to the doctrine of continuity of interest as indicating the meaning to be attributed to the term "securities" as used in the non-recognition provisions of the tax laws. It is clear, however, that the doctrine does not deal with the question whether a corporate note or any other obligation is a "security".

This Court first announced the doctrine of continuity of interest in *Pinellas Ice & Cold Storage Company* v. *Commissioner, supra.* That case involved a sale by one corporation to another of all its assets for a money consideration to be paid partly in cash and the balance in installments evidenced by short term promissory notes, the longest of which ran for only fifteen weeks. This Court said:

> "The court below held that the facts disclosed failed to show a 'reorganization' within the statutory definition. And, in the circumstances, we approve that conclusion.
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> "• • • the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption, the seller must acquire an interest in the affairs of the pur-

> chasing company more definite than that incident to ownership of its short-term purchase-money notes" (pp. 469-470).

This case did not hold that the short-term purchase money notes involved were not "securities." It held that the transaction was not a "reorganization" within the statutory definition, but was in fact a sale.

In *LeTulle* v. *Scofield, supra,* all the assets of one corporation were transferred to another corporation for cash and bonds of the transferee payable serially over a period of eleven years. Immediately after the transfer the entire consideration received by the transferor was distributed to the taxpayer, its sole stockholder. This Court held that the transaction did not qualify as a "reorganization" under Section 112(i) of the Revenue Act of 1928, since the transferor failed to acquire a proprietary interest in the transferee. This Court said:

> "In applying our decision in the *Pinellas* case the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. *There has naturally been some difficulty in classifying the securities involved in various cases.*
>
> "We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake

> only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute" (pp. 420-421). (Italics supplied.)

These cases involve only the definition of the term "reorganization", in substance requiring that the transaction partake of the nature of merger or consolidation, and that there be a continuity of interest in the enterprise. Thus in the *LeTulle* case the Court referred only to Section 112(i) of the Revenue Act of 1928, the section which defines the term reorganization for the purposes of that Act. *That section does not contain the term "securities".*

In all previous cases the continuity of interest doctrine is applied not to what is surrendered or extinguished in the exchange, but to what is received. Since the decision in the *LeTulle* case, it has been assumed that the doctrine requires the *acquisition* of a "proprietary interest" in the enterprise. The Circuit Court of Appeals, however, has construed the doctrine to require the transferor to have a "proprietary interest" in the enterprise *before the exchange.*

The decision of the court below thus makes a novel extension of the continuity of interest doctrine. It is submitted that this decision misapplies the decisions of this Court in the *Pinellas* and *LeTulle* cases and is an unwarranted extension of the scope of those decisions. Moreover, this Court held in *Helvering* v. *Alabama Asphaltic Limestone Company,* 315 U. S. 179 (1942), that the requirements of the continuity of interest doctrine were satisfied where creditor interests were relinguished in foreclosure proceedings for stock of the new company.

III.

The decision of the Circuit Court of Appeals, holding that corporate notes are not "securities" under the non-recognition provisions of the Revenue Acts, raises a novel and important question of construction of Federal law which should be settled by this Court.

The term "securities" is not defined in the Revenue Act of 1936 or the Regulations thereunder. In the absence of a definition, the language of a statute is to be read in its natural and common meaning (*Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552 (1932)), and the natural and common meaning of the term "security" indisputably comprehends promissory notes. Thus Webster's "New International Dictionary" defines the term as follows:

> "That which secures or makes safe. Specif: Something given, deposited, or pledged, to make secure, or certain the fulfillment of an obligation, the payment of a debt, etc.
>
> "Specif: An evidence of debt or of property, as a bond, stock certificate, or other instrument; a document giving the holder the right to demand and receive property not in his possession."

Abbott's "Dictionary of Terms and Phrases used in American or English Jurisprudence" (1879), contains the following statement:

> "Securities (plu.) is in use as a general term for written assurances for payment of money; evidences of debt."

Anderson's "A Dictionary of Law" (1893), contains the following definition:

> "Securities. Written assurances for the return or payment of money; evidences of indebtedness."

The Bureau of Internal Revenue, in an early ruling based upon an extended analysis of the authorities, concluded that, in the absence of a definition in the statute requiring a special or restricted meaning, the term "securities" included promissory notes in popular acceptation (GCM 2000, VI-2, C.B. 248 (1927)). In GCM 3291, VII-1 C.B. 203, published in 1928, the General Counsel of the Bureau of Internal Revenue ruled, again in the absence of a definition in the statute, that where stock was exchanged for stock and three months debenture notes of the transferee, the debenture notes were securities and the cost of the stock transferred should be allocated to the stock and notes received in proportion to their respective market values. Again in the absence of a definition in the statute, the Treasury Department defined the meaning of the phrase "stock or securities" as used in Section 351(b) of Title 1A of the Revenue Act of 1934, imposing the surtax on personal holding companies, as including "* * * bonds, debentures, certificates of indebtedness, notes * * *" (Regulations 86, Article 351-2(5)). The same definition is continued in the corresponding section of the present regulations (Regulations 111, Section 29.502.1(5)).

Congress itself has repeatedly defined the term "security" as including promissory notes (Securities Act of 1933, Section 2(1); Section 23(k)(3), Revenue Act of 1938; Section 215(a) of the Revenue Act of 1939, amending Section 22(b)(9) of the Internal Revenue Code; Supplement R to the Internal Revenue Code, Section 373(f)).

Further examples of definitions and interpretations of the term "securities" by lexicographers, the Bureau of Internal Revenue, Congress and the courts could be given, but the foregoing make it perfectly clear that the term "securities" includes promissory notes both in common parlance and in law, and further, that when Congress intends to use the term in a special or restricted sense, it provides an express definition for the guidance of the taxpayer and the courts.

The restricted meaning attributed to the term "securities" by the decision below unnecessarily impedes court-supervised corporate readjustments in 77B or Chapter X proceedings. Only by giving the term its natural and commonly accepted meaning can the non-recognition provisions of the tax law be correlated with the provisions governing bankruptcy reorganizations and related proceedings.

IV.

An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions is important to a proper administration of the revenue laws.

Congress has continued in the Revenue Acts subsequent to 1936, and in the Internal Revenue Code, provisions identical with the exchange provisions of the Revenue Act of 1936 applicable in the instant case. The question whether a corporate note may be a security for the purposes of such provisions is thus a question of continuing and general importance.

The problem has become more important than ever since the enactment of the Revenue Act of 1943. Section 121 of that Act adds Section 112(b)(10) and (l) to the Internal Revenue Code. These provisions are set forth in Appendix B. Section 112(l) provides that "no gain or loss shall be recognized upon . . . the relinquishment or extinguishment of stock or *securities* in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (b) (10) [which includes a 77B or Chapter X proceeding], in consideration of the acquisition solely of stock or *securities* in a corporation . . . made use of to effectuate such plan of reorganization." If the exchange occurred in a taxable year beginning prior to January 1, 1943, as it did in the instant case, then under Section 112(l)(2)(B) the gain or loss is recognized or not recognized "to the extent that it would be recognized or not recognized under the latest treatment of such exchange" by the taxpayer prior to December 15, 1943, in connection with his tax liability for such taxable year.

Section 112(l) is deemed to be included in the Revenue Acts respectively applicable to taxable years beginning after December 31, 1931, as provided by Section 121(e) of the 1943 Act. If the notes relinquished by petitioner for new debentures and common stock of the reorganized debtor are held to be "securities", then the provisions retroactively added to the Revenue Act of 1936 by the Revenue Act of 1943 apply.

At the present time, because of the unsettled status of the law, the Treasury Department is forced to argue both sides of the question whether a corporate note may be a security within the meaning of the non-recognition provisions of the tax law, thus greatly increasing the expense of administering the revenue laws. An equal burden is

imposed on the many taxpayers who have given or received corporate notes in connection with exchanges, recapitalizations and reorganizations.

For example, in *Hoagland Corporation* v. *Helvering*, 121 F. (2d) 962 (C. C. A. 2nd, 1941), the taxpayer owned all the stock and a demand note of a second corporation. There was a reorganization of the latter corporation under Section 77B in which the taxpayer relinquished its stock and note and received in exchange therefor stock of the reorganized corporation.

The taxpayer claimed a loss as a result of the above exchange. The Commissioner of Internal Revenue denied the deduction on the ground that there had been a reorganization. The Commissioner relied primarily upon the *Burnham* case, *supra*, stating in his brief before the Second Circuit:

> "The Board also denied petitioner a loss upon the exchange of its promissory note for Class B Stock under the plan of reorganization and in so doing treated the note as being in the same category as the stock of the corporation and as controlled by section 112(b)(3), *infra*. Such a result treats the promissory note as a 'security' of the reorganized corporation upon which no gain or loss is recognized under the reorganization provisions. This holding is supported by *Burnham* v. *Commissioner*, 86 F. (2d) 776 (C. C. A. 7th), certiorari denied 300 U. S. 683, *which case is squarely in point.*
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> "* * * It is now established by the decision of the Supreme Court in *LeTulle* v. *Scofield*, 308 U. S. 415, 420, that the 'term of the obligation is not material.' * * *" (Brief, p. 9). (Italics added.)

The Second Circuit affirmed the Board's decision holding that there had been an exchange of "stock or securities"

in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization. Thus, so far the Commissioner has successfully argued that the notes relinquished by petitioner were not "securities" and also has been successful in two other Circuits in taking the opposite view.

The most recent decision of the Tax Court on the question whether corporate notes are "securities" overrules the Commissioner's contention that five year notes redeemable by the maker on 30 days' notice are not securities. *Pan American Trust Company* v. *Commissioner,* T. C. Memo. Op. C. C. H. Dec. 14,587 (M), entered May 28, 1945.

It is submitted that a review by this Court of the instant case would serve to eliminate the doubt and uncertainty and the resulting burden of litigation, both for the Treasury Department and taxpayers.

Conclusion.

For the foregoing reasons the decision of the Circuit Court of Appeals should be reviewed by this Court.

Respectfully submitted,

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